

Northwestern Journal of International Law & Business

Volume 30

Issue 3 *Summer*

Summer 2010

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Recommended Citation

Jefferson P. VanderWolk, Inversions under Section 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance, 30 Nw. J. Int'l L. & Bus. 699 (2010)

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Inversions under Section 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance

Jefferson P. VanderWolk

The Obama Administration's international tax proposals would, if enacted, be likely to increase the U.S. tax costs of many multinational groups that are owned by a U.S. entity.¹ One possible response by the managers or owners of such a group would be to restructure the group via an inversion transaction so that the group would have a foreign corporate parent instead of a US parent entity.

Inversions were in vogue in the late 1990s and the early years of this decade until Congress passed the American Jobs Creation Act of 2004,² adding section 7874 to the Internal Revenue Code. The new law effectively negated the tax benefits of inversions into tax haven parent corporations where the ownership of the group was not significantly affected by the restructuring. If, on the other hand, there was a significant change in ownership and if the change was not due to a public offering of shares in the foreign corporation, the new law sought only to impose U.S. tax on gains accrued by the U.S. parent up to the date of expatriation without being offset by foreign tax credits or net operating loss carryovers. If the group had substantial business activities in the foreign corporation's country of incorporation, the new law would not apply.

The language of section 7874 raised a number of issues requiring guidance from the IRS and the Treasury Department in order to prevent absurd results.³ The statute also contained unclear terms needing clarification in regulations.⁴ In addition, the statute empowered the IRS and Treasury to write regulations "to prevent the avoidance of the purposes" of the section.⁵ This power has been exercised several times.⁶

¹ James Reardon & Jon Ohm, *The Practical Effects of the Obama International Tax Proposals*, 2009 TAX NOTES TODAY 171-76 (2009).

² American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

³ See T.D. 9238, 2006-1 C.B. 408.

⁴ For example, under I.R.C. § 7874(a)(2)(B)(iii) (2006), an inversion is not subject to the statute if, after the transaction, the controlled group "does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of [the] group."

⁵ I.R.C. § 7874(g) (2005).

Section 7874 is widely believed to have had a severe chilling effect on inversions of publicly held corporations, but these inversions may stage a comeback. In addition to potentially increased tax costs due to new international tax rules, factors such as reduced unrealized gains due to the economic downturn of 2008-2009 and rapid growth in foreign markets might lead to more inversions in the future. It is timely, therefore, to review the workings of section 7874 and the guidance issued by the IRS and the Treasury Department on major issues arising under the statute.

Part 1 of this article will introduce the statute and discuss its legislative history. Part 2 will explain in more detail how the statute works. Part 3 will critically discuss particular guidance issued in 2009 relating to the ownership-change determination. Part 4 will discuss the business-activities test, regulatory guidance on its application, and the implications of the subsequent elimination of much of that guidance. Part 5 contains concluding observations.

I. INTRODUCTION TO THE STATUTE AND ITS LEGISLATIVE HISTORY

Section 7874 applies when a foreign corporation (FC) acquires the stock or assets of a domestic corporation or partnership (UST) if both of the following conditions are satisfied: (1) at least 60% of the stock of FC is owned, after the acquisition, by former owners of UST by reason of their former ownership; and (2) the corporate group controlled by FC after the acquisition does not have business activities in FC's country of incorporation that are substantial when compared to the total business activities of the group worldwide. If the level of ownership continuity is between 60% and 80%, the statute imposes a special gain recognition requirement on UST and any related domestic entities for the ten-year period following the acquisition. If the level of ownership continuity is 80% or more, the statute does not impose the special gain recognition requirement, but instead deems FC to be a domestic corporation for all purposes of the Code.

Section 7874 was enacted after Congress had become aware that a number of multinational businesses owned by U.S. parent entities had been restructured in order to have a foreign corporation (typically incorporated in a tax haven such as Bermuda) be the owner of the business going forward.⁷ The former U.S. parent entity, or its assets, would be acquired by the new foreign parent (i.e., FC), which would be owned, at least in part, by the same owners who had previously owned the former U.S. parent entity (i.e.,

⁶ See T.D. 9238, 2006-1 C.B. 408; T.D. 9265, 2006-2 C.B. 1; T.D. 9399, 2008-1 C.B. 1157; T.D. 9453, 2008-28 I.R.B. 114 (2009).

⁷ See, e.g., David Cay Johnson, *U.S. Corporations Are Using Bermuda to Slash Tax Bills*, N.Y. TIMES, Feb. 18, 2002, at A1; *U.S. Firm Ditches Tax Dodge*, B.B.C. NEWS, Aug. 2, 2002, available at <http://news.bbc.co.uk/1/hi/business/2167602.stm>.

UST).⁸

The non-U.S. subsidiaries in the group could then be transferred to FC, thus removing their future earnings from the U.S. tax base. Also, FC or its foreign subsidiaries would be able to erode the U.S. tax base by making loans or licensing foreign-owned intangibles to the U.S. members of the group. Many members of Congress viewed such business expatriations motivated by tax avoidance as unpatriotic and unacceptable.⁹ A number of anti-inversion bills were introduced in 2002 and 2003,¹⁰ but no legislation on the issue was passed until the enactment of section 7874 as part of the Jobs Act in 2004.

Section 7874 is a hybrid, incorporating the anti-inversion approaches of both the House bill and the Senate bill that were combined to produce the Jobs Act.¹¹ The Senate bill provided for FC to be treated as a domestic corporation in cases of 80% or more continuity of ownership and for UST to be subject to the special gain recognition rules for ten years in cases of 50% to 80% continuity of ownership.¹² The House bill, in contrast, would have respected FC as a foreign corporation in all cases and subjected UST to the special gain recognition rule in cases of at least 60% continuity of ownership.¹³

Both bills gave a free pass to transactions where FC is incorporated in a country in which the group has substantial business activities in comparison to the group's worldwide business activities.¹⁴

Regarding the continuity-of-ownership calculation, both bills provided for the disregard of stock of FC sold in a public offering related to the inversion.¹⁵ The Senate bill, however, also provided for the disregard of stock of FC sold in a private placement related to the inversion.¹⁶ This was dropped from the final legislation.

The committee reports are surprisingly brief regarding the purposes of

⁸ In the simplest form of inversion, the UST would establish FC as a new foreign corporation, and the shareholders of UST would then contribute their shares of UST to FC in exchange for stock of FC. This is sometimes referred to as a "flip" transaction.

⁹ See, e.g., John D. McKinnon, *Senators Plan to Curb Relocations to Bermuda, Other Tax Havens*, WALL ST. J., Mar. 22, 2002, at A4.

¹⁰ See, e.g., Corporate Patriot Enforcement Act of 2002, H.R. 3884, 107th Cong. (2002); Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Cong. (2002); H.R. 4993, 106th Cong. (2000); American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong.

¹¹ American Jobs Creation Act of 2003, H.R. 2896, 108th Cong. § 601; Jumpstart our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 441 (2003).

¹² S. 1637.

¹³ H.R. 2896.

¹⁴ See *supra* note 11.

¹⁵ *Id.*

¹⁶ S. 1637. The words "or private placement" followed the words "public offering" in the provision that became I.R.C. § 7874(c)(2)(B).

the section. The entire “Reasons for Change” section of the Senate Finance Committee’s Report is as follows:

The Committee believes that inversion transactions resulting in a minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed. In particular, these transactions permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion, but with the result that the inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on domestic operations. The Committee believes that certain inversion transactions (involving 80 percent or greater identity of stock ownership) have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes. The Committee believes that other inversion transactions (involving greater than 50 but less than 80 percent identity of stock ownership) may have sufficient non-tax effect and purpose to be respected, but warrant heightened scrutiny and other restrictions to ensure that the U.S. tax base is not eroded through related-party transactions.¹⁷

The corresponding section of the House Ways and Means Committee’s report is quite different:

The Committee believes that corporate inversion transactions are a symptom of larger problems with our current uncompetitive system for taxing U.S.-based global businesses and are also indicative of the unfair advantages that our tax laws convey to foreign ownership. The bill addresses the underlying problems with the U.S. system for taxing its global businesses and contains several provisions to remove the incentives for entering into inversion transactions. Imposing full U.S. tax on gains of companies undertaking an inversion transaction is one such provision that helps to remove the incentive to enter into an inversion transaction.¹⁸

The Conference Report and the Joint Committee on Taxation’s “Blue Book” say nothing further about the purposes of section 7874.¹⁹

The Senate Finance Committee’s report indicates that the perceived mischief had two elements. One was the fact that the group could “continue to conduct business in the same manner as they did prior to the inversion,” but with reduced US tax exposure.²⁰ The other element was the

¹⁷ S. REP. NO. 108-192, at 142 (2003).

¹⁸ WILLIAM M. THOMAS, COMM. ON WAYS AND MEANS, H.R. REP. NO. 108-393, at 163 (2003).

¹⁹ H.R. REP. NO. 108-755, at 568 (2004) (Conf. Rep.); Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, at 343 (May 2005).

²⁰ S. REP. NO. 108-192, at 142.

group's "minimal presence" in FC's country of incorporation.²¹ Thus, the legislators viewed some inversions as involving a mere change of form with little or no substantive economic effect in cases where the group's ownership did not change by more than 20%, and the group's presence in FC's country of incorporation was minimal. In such cases, the statute would eliminate any U.S. tax benefit from the transaction by treating FC as a U.S. corporation.

In contrast, it was decided that FC should be respected as a foreign corporation for U.S. tax purposes if there was either a bigger change of ownership or a more-than-minimal presence of the group in FC's country of incorporation. The report indicates that the Senate believed these transactions would have a sufficient non-tax effect to justify being respected for U.S. tax purposes. Cases involving minimal presence in the foreign country and an ownership change of at least 50% but less than 80% would be subjected to "heightened scrutiny and other restrictions to ensure that the U.S. tax base is not eroded through related-party transactions."²²

The House Ways and Means Committee's report signals agreement with the Senate on the last point only, and even that is only partial agreement since the House bill had a 60% threshold rather than 50%, and made no distinction between cases on either side of the 80% ownership change line.

Despite the importance of the ownership-change percentage to the policy underlying section 7874, the committee reports say nothing about the reason for disregarding stock of FC sold in a public offering related to the inversion. A plausible guess is that the legislators felt that a widely dispersed group of new shareholders would not have a significant effect on the conduct of the group's business. It would follow by implication that the conference committee thought that a small group of new investors who privately acquired more than 20% ownership might have a significant effect on the conduct of the business.

II. THE WORKINGS OF SECTION 7874

Section 7874 begins with the operative provision for covered inversions with an ownership change of at least 60% but less than 80%: "The taxable income of an *expatriated entity* for any taxable year [in the ten-year period following the completion of the inversion transaction] shall in no event be less than the *inversion gain* of the entity for the taxable year."²³

Inversion gain is defined as "the income or gain recognized by reason

²¹ *Id.*

²² *Id.*

²³ I.R.C. § 7874(a)(1) (2006). Key concepts are italicized in this article to aid understanding.

of the transfer during the [ten-year] period of stock or other properties by an *expatriated entity*, and any income received or accrued during the [ten-year] period by reason of a license of any property by an *expatriated entity* . . . as part of the [inversion transaction], or . . . after [it] if the transfer or license is to a foreign related person.”²⁴

Expatriated entity is defined in paragraph (2)(A) as a “domestic corporation or partnership . . . with respect to which a foreign corporation is a *surrogate foreign corporation*”.²⁵

Surrogate foreign corporation is then defined in paragraph (2)(B). In broad terms, a surrogate foreign corporation is a foreign corporation that has acquired all of the stock or assets of a domestic corporation or partnership if after the acquisition at least 60% of the foreign corporation’s stock is owned by former shareholders or partners of the domestic entity by reason of their holding stock or partnership interests in the domestic entity, and the group does not have business operations in the foreign acquirer’s country of incorporation that are substantial compared to the worldwide operations of the group.²⁶

Thus, the surrogate foreign corporation is FC, the new foreign parent; the expatriated entity is UST, the former U.S. parent; and the inversion gain is the income and gain of UST and its U.S. affiliates which arises from transfers to foreign related persons.

While the foregoing sections seem clear, the statute gets more complicated. Subsection (b) provides for a foreign corporation to be treated as a domestic corporation if it would be a surrogate foreign corporation if the 60% continuity-of-ownership requirement were changed to 80%. Another provision prevents subsection (b) cases from being affected by the inversion-gain inclusion rule of subsection (a).

The statute includes several so-called “special rules.” One is the public-offering rule: for purposes of determining continuity of ownership, no account shall be taken of stock of FC “which is sold in a public offering” related to the inversion transaction.²⁷ Another rule disregards any transfers of properties or liabilities “if such transfers are part of a plan a principal purpose of which is to avoid the purposes of this section.”²⁸

Congress made two separate grants of regulatory authority to the IRS and Treasury in section 7874. The more narrow grant was “to prescribe

²⁴ I.R.C. § 7874(d)(2) (2006). Additional provisions limit the taxpayer’s ability to use foreign tax credits and net operating losses to reduce the taxation of inversion gain. I.R.C. § 7874(e)(1), (3) (2006).

²⁵ I.R.C. § 7874(a)(2)(A)(i) (2006). A United States person related to an expatriated entity under section 267(b) or 707(b)(1) of the Code is also an expatriated entity under section 7874(a)(2)(A)(ii) (2006).

²⁶ I.R.C. § 7874(a)(2)(B)(i)-(iii) (2006).

²⁷ I.R.C. § 7874(c)(2)(B) (2006).

²⁸ I.R.C. § 7874(c)(4) (2006).

such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations (A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and (B) to treat stock as not stock.”²⁹ The broader grant was for

such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through (1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or (2) transactions designed to have persons cease to be (or not become) members of [corporate groups] or related persons.³⁰

III. THE OWNERSHIP-CHANGE TEST AND THE PUBLIC-OFFERING RULE: NOTICE 2009-78

On September 17, 2009, the IRS and Treasury announced, in Notice 2009-78³¹ (the “Notice”), that for purposes of determining the percentage of FC stock that is held by former owners of UST, they will disregard FC stock issued in an offering related to FC’s acquisition of UST if the stock is issued in exchange for cash or highly liquid assets, regardless of whether the FC stock is issued in a public offering or a private placement.³²

Specifically, stock issued in exchange for “nonqualified property” will be disregarded under forthcoming regulations. Nonqualified property is defined as cash or cash equivalents, marketable securities, and “any other property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874.”³³

The Notice describes a transaction that is said to be “intended to avoid the application of section 7874”:³⁴

The shareholders of [UST] transfer all their [UST] stock to [FC] in exchange for 79 percent of the stock of [FC] and, in a related transaction, an investor transfers cash to [FC] in exchange for the remaining 21 percent of the [FC] stock. . . . [T]he parties assert that the investor’s [FC] stock would be taken into account for purposes of [determining the percentage of FC owned by former owners of UST by reason of their ownership of UST stock]. Thus, the former shareholders of UST would hold only 79 percent of the stock of FC

²⁹ I.R.C. § 7874(b)(6) (2006).

³⁰ I.R.C. § 7874(g) (2006).

³¹ I.R.S. Notice 2009-78 (Sept. 17, 2009).

³² *Id.*

³³ *Id.*

³⁴ *Id.*

by reason of holding stock of UST, in which case section 7874(a)(1) would apply to UST (and any other expatriated entity) but section 7874(b) would not apply to treat [FC] as a domestic corporation for purposes of the Code. . . . [This] is inconsistent with the purposes of section 7874.³⁵

No explanation is given for the conclusion that taking the new investor's stock into account is inconsistent with the purposes of section 7874. In fact, nowhere in the Notice are the purposes of section 7874 summarized or otherwise stated. It is puzzling also that the Notice first asserts that the transaction is intended to avoid the application of section 7874 but then states that the taxpayer takes the position that section 7874(a)(1) is applicable to UST and any other expatriated entity. It may be argued that notices issued by Treasury and the IRS do not have to provide explanations, but if a Notice asserts that a scenario is inconsistent with the purposes of a statutory provision, it does not seem unreasonable to expect that some indication of the rationale for the assertion will be provided.

The transaction appears to be intended to avoid the application of section 7874(b), but not 7874(a)(1), by limiting the percentage of continuing ownership to 79%. This is qualitatively different from avoidance of the section. As discussed further below, if the new investor's interest in FC is a genuine 21% equity interest not limited by any kind of restrictions on the investor's rights, then the application of section 7874(a)(1) is fully consistent with the statutory purpose.

Two additional examples are given in the Notice, describing direct and indirect exchanges of marketable securities for stock of the new foreign parent and stating the conclusion that the latter stock will be disregarded under the future regulations. In the second example, which involves the indirect exchange, a reason is given for the conclusion: "because a principal purpose of such issuance is the avoidance of the purposes of section 7874."³⁶ This is odd, as the examples contain no information on ownership percentages, and thus it is impossible to tell whether section 7874 would apply or not if the stock were not disregarded.³⁷

What might be the thinking behind the Notice? Regarding the example with a 79%-21% split of the ownership of FC, one's initial

³⁵ *Id.*

³⁶ *Id.*

³⁷ Separately, the Notice states that the IRS and Treasury will not rely on the public-offering rule to disregard FC stock issued in exchange for publicly traded stock of a foreign target company that is acquired by FC at the same time as FC's acquisition of UST's stock or assets. Again, no explanation is given other than a simple statement that disregarding the FC stock and treating FC as a domestic corporation in these circumstances "could be inappropriate in certain cases." *Id.* This is clearly correct since it would be a semantic stretch to treat stock issued to target shareholders in exchange for their stock in the target as stock "sold in a public offering," and there would be no policy reason to do so in any case.

reaction is that the IRS and Treasury presumably felt that there was no policy reason to treat a 79% case and an 80% case differently, and that they had sufficiently broad regulatory authority to write a rule treating the two cases the same way. The initial reaction does not explain, however, the fact that the rule stated in the Notice would apply to cases in which the actual change of ownership was much larger than 21%. Indeed, the rule is not limited even to cases of continuing ownership of a majority stake in FC; it could apply in a case in which 99% of FC was owned by new investors. Thus, it appears that the IRS and Treasury must have concluded that their regulatory authority was broad enough to allow them to disregard stock issued in exchange for cash or highly liquid assets in all cases on the theory that such an exchange might result in an FC-owned structure that was not caught by section 7874(b) but was economically similar to one that would have been caught—namely, an FC wholly owned by former UST shareholders and carrying on the same business minus only some cash or highly liquid assets.

It does not appear, however, when one looks carefully at the purposes of section 7874 as expressed in both the language of the statute and the legislative history that the IRS and Treasury actually have so much regulatory authority.

First, Congress decided that there *was* a policy reason to treat an inversion with 79% continuity of ownership differently from an inversion with 80% continuity of ownership except in cases where the discontinuity was the result of a public offering. The 80% test is a bright-line test. Bright-line tests always give rise to the policy question of why cases that are very close to the line on either side should be treated differently. As a matter of practicality, however, a line often needs to be drawn, and people need to know exactly where the line is. A bright line inevitably enables people to arrange their affairs so as to be on one side of the line or the other, depending on which treatment they prefer. The U.S. Supreme Court has noted that “the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it.”³⁸

Of course, the question of whether a bright line has been passed must be answered by looking at the substance of the matter and not merely the form. For example, section 957 of the Code defines “controlled foreign corporation” using a bright-line 50% stock ownership test (by either value or voting power).³⁹ The regulations under section 957 provide that “any

³⁸ *Superior Oil Co. v. Mississippi ex rel. Knox*, 280 U.S. 390, 395–96 (1930) (citing *Bullen v. Wisconsin*, 240 U.S. 625, 630–31 (1916)). In the tax area, the Supreme Court expressed a similar view in *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) (“The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.”). For the quotation from *Superior Oil Co.*, I am indebted to the unnamed author of *Drawing Lines Around Corporate Inversion*, 118 HARV. L. REV. 2270, 2270 (2005).

³⁹ I.R.C. § 957(a) (2006).

arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained” and go on to provide illustrative examples.⁴⁰ This was an entirely appropriate bit of rule-making by the IRS and Treasury.

It would not have been permissible for the IRS and Treasury to write regulations under section 957 treating a foreign corporation as a controlled foreign corporation if it is 49.9% owned by United States shareholders when in reality those shareholders merely have 49.9% of the voting power and value of the company’s stock. Similarly, it is not appropriate to treat the 79%-21% example in the Notice as an 80% case simply because 79% is very close to 80%, and it can be inferred that 79% was chosen as part of a plan to have the inversion fall under section 7874(a)(1) rather than section 7874(b). Provided that the new investor’s stock in FC gives the investor a genuine 21% equity interest in the group, reducing the former owners’ interest to 79% in substance, there is no basis for concluding that the treatment provided for under the plain language of the statute is in conflict with legislative intent.

The IRS and Treasury issued the Notice in reliance on the grants of regulatory authority in section 7874, which allow for regulations “to determine whether a foreign corporation is a surrogate foreign corporation” and “to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section.”⁴¹ These provisions, as well as the rule which disregards any transfers made as part of a plan a principal purpose of which is to avoid the purposes of section 7874,⁴² are cited in the background section of the Notice.

Let’s consider each grant of authority in turn. First, does the authority to write rules “to determine whether a corporation is a surrogate foreign corporation” give the IRS and Treasury a blank sheet of paper on which to write a new definition of “surrogate foreign corporation?”⁴³ The answer must be no. The phrase “surrogate foreign corporation” has no meaning outside of section 7874. The only basis for determining what is a surrogate foreign corporation is the language of section 7874(a)(2)(B). The regulatory authority granted in paragraph (c)(6) permits the writing of rules which negate arrangements designed to avoid surrogate foreign corporation status in form but not substance.⁴⁴ This is clearly indicated by the examples

⁴⁰ Treas. Reg. § 1.957-1(b)(2) (as amended in 1997).

⁴¹ I.R.C. § 7874(c)(6), (g) (2006). An IRS official confirmed in a public forum that the grants of regulatory authority were important factors in the decision. See John Merrick, Special Counsel, I.R.S. Office of Assoc. Chief Counsel, Remarks at the American Bar Association Section of Taxation meeting (Sept. 25, 2009), in *TAX ANALYSTS*, 2009 WTD 186-2 (Sept. 29, 2009).

⁴² I.R.C. § 7874(c)(4) (2006).

⁴³ I.R.C. § 7874(b)(6)

⁴⁴ I.R.C. § 7874(c)(6).

stated in paragraph (c)(6) itself, namely regulations “to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and . . . to treat stock as not stock.”⁴⁵ It follows that the Notice’s treatment of the 79%-21% case as an 80%-20% case is not authorized by paragraph (c)(6) in a case where the former owners’ 100% interest in the group was, in substance, diluted to a 79% equity interest.

Second, is the authority to make rules “to prevent the avoidance of the purposes of the section” broad enough to support the Notice? The purposes of the section are indicated by the language of the section, read purposively in light of the legislative history. The fact that the statute explicitly provides for the disregard of stock sold in a public offering but not stock sold in a private placement is not conclusive, but it does create a need for the IRS and Treasury to show that Congressional intent would be defeated by respecting stock issued in exchange for cash to one or more new investors through a private placement. The IRS and Treasury have to be able to hang their hat on relevant language in either the statute or the legislative history when they exercise their authority to write anti-avoidance regulations.

Congress said that section 7874 was intended to discourage inversions of U.S. parent entities into new foreign parent corporations having a minimal presence in the foreign country of incorporation. It classified such inversions into those having little or no non-tax effect or purpose and those having enough non-tax effect or purpose to be outside of the first category. It drew the statutory line between the two categories at 80% continuity of ownership. An inversion resulting in a real dilution of the former owners’ interest, through a private placement, by more than 20%, regardless of whether the new investors transfer cash, marketable securities, or some other form of property to the group in exchange for their stock in the new foreign parent, appears to have been considered by Congress to have enough of a non-tax effect to put the transaction into the second category.

Thus, applying section 7874(a)(1) appears to be fully consistent with Congressional intent as expressed in both the language of the statute and the legislative history. The broad grant of regulatory authority in section 7874(g) refers to “avoidance of the purposes of the section,” not avoidance of a particular part of the section by making a choice to be subject to another part of the section. Similarly, section 7874(c)(4) disregards transfers that are “part of a plan a principal purpose of which is to avoid the purposes of *this section*” (emphasis added).⁴⁶ The purposes of the section are not avoided by a plan that contemplates being subject to section 7874(a)(1) due to facts that, in substance, are consistent with what Congress had in mind when it enacted that provision.

The Notice could also lead to an absurd result in a case in which

⁴⁵ *Id.*

⁴⁶ I.R.C. § 7874(c)(4) (2006).

investors unrelated to UST had established FC and injected cash into it in exchange for stock, and, in a connected transaction, FC had acquired the stock or assets of UST by paying a mixture of cash and FC stock to the owners of UST. Only the FC stock held by the former UST owners would be counted in determining continuity of ownership under section 7874, and FC would be treated as a domestic corporation for U.S. tax purposes, even if only a tiny percentage of FC was actually owned by the former UST owners.

Under applicable standards for testing the validity of administrative regulations, the forthcoming regulations announced in the Notice will be vulnerable to a challenge. The *Chevron* standard, which was applied by the Third Circuit in the IRS's favor in *Swallows Holding* in 2008, does not permit the IRS to promulgate an interpretive regulation that conflicts with the unambiguous language of a statute.⁴⁷ There does not appear to be any ambiguity in section 7874 that is being interpreted in the Notice. The term "public offering" cannot be read as including a private placement by any stretch of the imagination. A court might take the view, however, that the grants of regulatory authority in section 7874 have the effect of creating statutory ambiguity with respect to transactions that arguably are inconsistent with the purposes of the statute. In that case, the second leg of the *Chevron* analysis would require the court to examine the reasonableness of the agency's rule in light of all relevant evidence as to legislative intent, including the words of the statute and the legislative history.⁴⁸ For the reasons discussed above, the regulations announced in the Notice do not appear to be a reasonable exercise of regulatory authority.

IV. THE BUSINESS ACTIVITIES TEST AND TD 9453

In contrast to the bright-line test of 80% ownership in section 7874(b), the business-activities test in section 7874(a)(2)(B)(iii) draws a very fuzzy line, the crossing of which has enormous consequences. If the group's business activities in the foreign parent's country of incorporation are substantial when compared to the total worldwide business activities of the group, section 7874 does not apply. Unfortunately, the adjective "substantial" is ambiguous. The American Heritage Dictionary supplies six different definitions, the most pertinent of which is "considerable in importance, value, degree, amount, or extent."⁴⁹ The adjective

⁴⁷ See *Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162, 167–72 (3d Cir. 2008) (citing *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) *passim*). Regulations issued under a grant of authority to write rules to carry out the purposes of a statute or prevent the avoidance of its purposes are interpretive, not legislative, regulations. See, e.g., *Tutor-Saliba Corp. v. Comm'r*, 115 T.C. 1, 14 (2000) (regarding a regulation issued under I.R.C. § 460(h)).

⁴⁸ *Chevron*, 467 U.S. at 842–43.

⁴⁹ AMERICAN HERITAGE DICTIONARY 1727 (4th ed. 2000).

“considerable” is defined as “fairly large in amount, extent, or degree.”⁵⁰ The relevant definition of “fairly” is “moderately”⁵¹ and, in circular fashion, the relevant definition of “large” is “of considerable size, extent, quantity, capacity, or amount.”⁵²

Thus, the substantiality standard of the business-activities test in section 7874 appears to require that the group’s business activities in FC’s country be of moderately considerable size in comparison to the group’s total worldwide activities. Such a requirement is vague; certainly not anything like a bright line. It works well enough for the type of inversions that prompted the enactment of section 7874, where FC is incorporated in Bermuda and the group has virtually no business in Bermuda. But what if a group’s managers or owners are considering a potential inversion in which FC would be incorporated in the United Kingdom, and the group’s U.K. activities comprise between 5% and 10% of the group’s worldwide activities? Is that “substantial” when compared to the global business? What if the U.K. activities were 15% of the global total, or 25%, or 35%? There is simply no way of knowing where the line is based on the language of the statute.

For a group that conducts significant business activities in many different countries, the business-activities test would be impossible to satisfy if “substantial” were interpreted to mean “at least 50%,” or even “at least 20%.” It is likely that many global businesses are spread over a large number of countries such that no single country accounts for more than a single-digit percentage of the global business. Did Congress intend to create a condition that could not be met, in practice, in some cases? There is no evidence in the legislative history that this result was intended.

Taxpayers have a legitimate expectation that the law will be clear enough to be followed. Therefore, it is incumbent on the IRS and Treasury to provide guidance under section 7874 enabling taxpayers to have a reasonable degree of certainty as to whether the business-activities test would be satisfied in their case. To that end, the IRS and Treasury issued regulations on the business-activities test in June 2006.⁵³

The regulations included both a general facts-and-circumstances analysis of the substantiality standard and a safe harbor test. The preamble stated:

The IRS and Treasury Department believe that this dual approach appropriately provides taxpayers with the certainty of an objective and clear safe harbor, while preserving the ability of a taxpayer to conclude, in a case that is not within the scope of the safe harbor,

⁵⁰ *Id.* at 392.

⁵¹ *Id.* at 636.

⁵² *Id.* at 987.

⁵³ Temp. Treas. Reg. § 1.7874-2T (2006); T.D. 9265, 2006-2 C.B. 1.

that section 7874 is not applicable to a foreign entity's acquisition of the stock or assets of a domestic entity where, after the acquisition, the group has a meaningful and bona fide business presence in the relevant foreign country.⁵⁴

The heart of the facts-and-circumstances test is the list of factors that will be considered (or not considered) in making the determination of substantiality of business activities in the country:

(ii) *Factors to be considered.* . . . Relevant factors include, but are not limited to—

(A) *Historical presence.* The conduct of continuous business activities in the foreign country by [group] members prior to the acquisition;

(B) *Operational activities.* Business activities of the [group] in the foreign country occurring in the ordinary course of the active conduct of one or more trades or businesses, involving—

(1) Property located in the foreign country which is owned by members of the [group];

(2) The performance of services by individuals in the foreign country who are employed by members of the [group]; and

(3) Sales to customers in the foreign country by [group] members;

(C) *Management activities.* The performance in the foreign country of substantial managerial activities by [group] members' officers and employees who are based in the foreign country;

(D) *Ownership.* A substantial degree of ownership of the [group] by investors resident in the foreign country.

(E) *Strategic factors.* The existence of business activities in the foreign country that are material to the achievement of the [group's] overall business objectives.⁵⁵

Five examples illustrating the application of the facts-and-circumstances test were included in the regulation.⁵⁶

Under the safe-harbor test, a group would satisfy the substantiality

⁵⁴ T.D. 9265, 2006-2 C.B. 1.

⁵⁵ Temp. Treas. Reg. § 1.7874-2T(d)(1)(ii) (2006).

⁵⁶ Temp. Treas. Reg. § 1.7874-2T(d)(4) (2006).

standard if FC's country of incorporation accounted for at least 10% of the group's total employees (by both headcount and compensation), business assets (excluding intangibles), and sales.⁵⁷

In June 2009, the IRS and Treasury amended the regulations by eliminating the safe harbor and all of the examples.⁵⁸ The preamble to the amended regulation contains the following comments:

The IRS and the Treasury Department have concluded that the safe harbor provided by the 2006 temporary regulations may apply to certain transactions that are inconsistent with the purposes of section 7874, which is meant to prevent certain transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership). The [amended] temporary regulations, therefore, do not retain the safe harbor provided by the 2006 temporary regulations. The [amended] temporary regulations also do not retain the examples illustrating the general rule contained in the 2006 temporary regulations. Thus, taxpayers can no longer rely on the safe harbor or the examples illustrating the general rule provided by the 2006 temporary regulations. Instead, taxpayers must apply the general rule to determine whether the substantial business activities condition is satisfied. In addition, the question of whether the substantial business activities condition is satisfied will continue to be on the list of provisions with respect to which the IRS will not ordinarily issue rulings or determination letters.⁵⁹

As discussed earlier in this article, it is impossible for taxpayers to know, absent guidance from the IRS and Treasury, what "substantial" means for the purposes of the business-activities test in section 7874. By eliminating the regulatory safe harbor and the examples of the application of the facts-and-circumstances test, the IRS and Treasury are abdicating their responsibility to provide meaningful guidance.

The comments in the preamble are revealing: the purpose of section 7874 is "to prevent certain transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership)."⁶⁰ This statement betrays the purposes of the statute, as it deviates from the legislative history in two ways. First, Congress did not say that it wished to "prevent" inversions. Rather, it sought to negate or limit the U.S. tax benefits of tax-motivated inversions, with the tax consequences varying depending on the level of continuing ownership of the group. Preventing the owners of a business from reorganizing the legal entity structure of the business in a legal way would be inconsistent with

⁵⁷ Temp. Treas. Reg. § 1.7874-2T(d)(2) (2006).

⁵⁸ Temp. Treas. Reg. § 1.7874-2T (as amended in 2009); T.D. 9453, 2008-28 I.R.B. 114 (2009).

⁵⁹ T.D. 9453, 2008-28 I.R.B. 114 (2009).

⁶⁰ *Id.*

traditional American notions of freedom. The idea that the U.S. Congress would attempt to prevent the owners of an American business entity from transferring their interest in the entity to a foreign entity is untenable.

Second, Congress did not say that section 7874 was aimed at inversions that merely shift the place of organization of a domestic entity. Rather, Congress said that section 7874 was intended to apply to “inversion transactions resulting in a minimal presence in a foreign country of incorporation.”⁶¹ Shifting the place of organization of a domestic entity to a foreign country of incorporation in which the group has a substantial presence was always outside the scope of section 7874.

The preamble to the amended regulations arguably misrepresents the purposes of the statute. A more accurate statement of those purposes would have highlighted the need for meaningful guidance regarding the business-activities test.

The guidance that remains in the regulations consists of the non-exclusive list of factors to be considered in applying the facts-and-circumstances test. This list is not enough to give taxpayers a reasonably clear idea of what satisfies the substantiality standard. The elimination of the 10% safe harbor may be seen as creating an implication that the IRS and Treasury see the line as being somewhere above the 10% mark, but it remains impossible to know with certainty without further guidance.

V. THE NEED TO REFORM THE U.S. INTERNATIONAL TAX REGIME

The House Ways and Means Committee’s report on section 7874 indicated that, in the Committee’s view, inversions were a symptom of an underlying problem, namely, “our current uncompetitive system for taxing U.S.-based global businesses.”⁶² The House version of what became section 7874 did not seek to treat FC as a domestic corporation under any circumstances. Rather, the House version sought only to tax the inversion gain, if the relevant statutory conditions were met. The Committee indeed considered it appropriate to tax the inversion gain in cases where the continuing ownership was at least 60% and the group did not have substantial operations in FC’s country of incorporation; yet the Committee appeared to feel that it was more important for Congress to address the reasons leading U.S. multinationals to undertake inversion transactions.

The American Jobs Creation Act of 2004 did contain a number of measures aimed at alleviating the U.S. tax burden on foreign-source income of U.S. multinationals, such as a reduction in the number of separate baskets for purposes of determining the foreign tax credit limitation.

⁶¹ H.R. CONF. REP. NO. 108-755, *supra* note 19.

⁶² WILLIAM M. THOMAS, COMMITTEE ON WAYS AND MEANS, H.R. REP. NO. 108-393, at 163 (2003).

However, Congress left in place the fundamental framework of the U.S. international tax regime for domestic corporations conducting global business. The regime provides for residence-based taxation of global income subject to a foreign tax credit, with residence being determined solely by the country of incorporation. The foreign tax credit rules are highly complicated, requiring a great deal of time and effort to be spent by expensive specialists on the management of the group's global effective tax rate. In addition, the foreign-source income of controlled foreign subsidiaries of a U.S. parent corporation is potentially subject to U.S. taxation each year under a complex web of anti-deferral rules that also necessitate substantial time to be spent on tax management.

In comparison, multinational businesses conducted by corporate groups owned by a non-U.S. parent corporation generally have a lighter tax compliance burden, and often a lower global effective tax rate as well.⁶³ Most OECD countries provide a tax exemption for non-portfolio dividends from foreign affiliates' earnings that have been subjected to foreign income tax, thus eliminating the complexities of a foreign tax credit system and allowing low-taxed foreign-source income to remain low-taxed.⁶⁴ Moreover, the controlled foreign company rules in other countries are generally more narrowly targeted than the U.S. subpart F rules.⁶⁵ And all but one OECD member country impose corporate income tax at a lower rate than the U.S. federal corporate income tax rate.⁶⁶

The Obama Administration announced a set of international tax proposals in early May 2009.⁶⁷ The proposals would significantly increase the disparity of tax burdens between at least some U.S.-parented global

⁶³ See, e.g., John M. Samuels, *American Tax Isolationism*, 123 TAX NOTES 1593 (June 29, 2009) at p. 1594:

[T]he U.S. tax system is out of step with the tax system of virtually every major industrialized country in the world. Twenty-five of the twenty-nine OECD countries have adopted territorial tax regimes, leaving the United States as the only major industrialized country taxing the worldwide income of its resident multinationals. And the average corporate tax rate in OECD countries has steadily declined and is now 50 percent lower than the U.S. rate. Nor has any country adopted antideferral rules that are nearly as broad and far-reaching as the U.S. subpart F regime.

⁶⁴ *Id.*

⁶⁵ The U.K. rules, for example, contain a number of different exclusions, including an exclusion for any controlled foreign company with respect to which it can be shown that the company was not created for the purpose of reducing U.K. tax liability. HM Revenue & Customs Int'l Manual, *Controlled Foreign Companies*, available at <http://www.hmrc.gov.uk/manuals/intmanual/INTM200000.htm> (last visited Apr. 4, 2010).

⁶⁶ Japan has the highest corporate income tax rate among OECD countries, followed closely by the United States. OECD Tax Database, Table II.1 (2010), available at <http://www.oecd.org/ctp/taxdatabase> (last visited Sept. 4, 2010).

⁶⁷ U.S. DEP'T OF THE TREAS., GEN. EXPLANATION OF THE ADMIN.'S FISCAL YR. 2010 REVENUE PROPOSALS (MAY 2009), available at <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf> (last visited Apr. 4, 2010).

groups and their non-U.S.-parented competitors. Deferral of U.S. income taxation of foreign subsidiaries' foreign-source earnings would be more difficult under subpart F due to a new rule preventing the use of a check-the-box election to treat a foreign eligible entity as a disregarded entity for U.S. tax purposes, except in cases where the single owner of the entity was a corporation formed under the laws of the same country as the eligible entity.⁶⁸ Also, the deduction of expenses (other than research and development expenses) attributable to foreign-source income would be deferred until such time as the income was repatriated to the United States.⁶⁹ This would affect mainly the deductibility of worldwide interest expense as well as general and administrative expenses. A third proposal, of great significance to many U.S. multinationals, is the calculation of a U.S. parent's foreign tax credit limitation on the basis of the global pools of the group's foreign-source income and foreign income taxes. For some groups, this change would significantly reduce their ability to use the foreign tax credit to offset residual U.S. taxation of foreign-source income.

These proposals would enlarge and reinforce the differences between the U.S. international tax system and the international tax systems of U.S. trading partners; they would strengthen the existing residence-based taxation of U.S. corporations, in contrast with the international trend toward territorial taxation of corporate profits. Japan and the United Kingdom, for example, have recently adopted legislation making their tax rules for foreign-source dividends more like those of the continental European countries, which generally provide an exemption for foreign-source dividends paid out of foreign-taxed earnings.⁷⁰ In Canada, the Advisory Panel on Canada's System of International Taxation recommended, in its final report in December 2008, that the existing exemption system be broadened to cover all active foreign business income of foreign affiliates, as well as capital gains from the sale of foreign affiliate stock that derives its value primarily from active business assets.⁷¹

The Administration's proposals have generated a good deal of criticism from business groups such as the National Foreign Trade Council as well as prominent international tax practitioners such as James Fuller and Michael Durst.⁷² The gist of their criticism is that the U.S. economy would

⁶⁸ *Id.* at 28.

⁶⁹ *Id.* at 29.

⁷⁰ See Charles Gnaedinger, *Japanese, U.K. Exemption Systems Could Inform U.S. Tax Decisions*, WORLDWIDE TAX DAILY (2010), 2010 WTD 40-3, and sources cited therein.

⁷¹ Advisory Panel on Can.'s Int'l Tax Sys., Final Rep., *Enhancing Canada's International Advantage* 4.1 & 4.3 (2008), available at http://www.apcsit-gcrfi.ca/07/cp-dc/pdf/final_Report_eng.pdf.

⁷² Press Release, Nat'l Foreign Trade Council, *Addressing Offshore Tax Avoidance Without Harming the International Competitiveness of U.S. Businesses* (2009), <http://www.nftc.org/default/Tax%20Policy/International%20Tax/Final%20NFTC%20Paper%20addressing%20tax%20haven%20issues.pdf>; James P. Fuller, *U.S. Tax Review*, 54 TAX

be better off in the medium- to long-term if U.S. multinationals were subject to a more benign regime of residence-based taxation, given the ability of global businesses to move activities, investments, and people to other countries where tax costs are lower. As noted by the Canadian advisory panel, empirical studies indicate that outbound foreign direct investment by resident companies is more likely to help than to hurt the economy of the country of residence in the long term.⁷³ The Administration's proposals are based on the conflicting view that overseas investment by U.S. companies deprives the U.S. economy of jobs as well as tax revenue.⁷⁴

Section 7874 is the most extreme of the U.S. international tax rules aimed at preserving residence-based taxation of foreign-source earnings of U.S. multinationals. The deemed domestication of a foreign corporation not managed and controlled in the United States, under the 80% ownership change test of section 7874, is a radical assertion of tax jurisdiction in the context of international tax norms. The only conceivable justification for such treatment is that the new FC parent structure has no meaning or purpose other than the avoidance of U.S. income taxation, and is a mere alter ego of the former U.S. parent company (as the use of the term "surrogate" in the statute suggests). Whether this is likely to be true in any given case is doubtful, but even if it were true, a question would remain as to whether the imposition of residence-based taxation on a nonresident corporation for the indefinite future is appropriate.

The U.S. does not have a similarly broad deemed-domestication rule for individuals who cease to be subject to worldwide federal income taxation by relinquishing their citizenship or permanent residency rights. Rather, they are subject to tax on unrealized gains at the time of expatriation, and to tax on future gains from the sale of certain U.S.-connected assets under a special re-sourcing rule.⁷⁵ Such treatment is similar to what section 7874 provides for U.S. businesses in the event of an inversion involving a 60%-to-80% ownership change.

The U.S. international tax regime would be improved by the repeal of the deemed-domestication rule of section 7874(b), as part of a wider range

NOTES INT'L 773 (2009); Michael C. Durst, *The President's International Tax Proposals in Historical and Economic Perspective*, 54 TAX NOTES INT'L 747 (2009).

⁷³ Margit Molnar, Nigel Pain & Daria Taglioni, *The Internationalisation of Production, International Outsourcing and Employment in the OECD* (OECD Econ. Dept., Working Paper No. 561, 2007); P.S. Andersen & P. Hainaut, *Foreign Direct Investment and Employment in the Industrial Countries* (Bank for Int'l Settlements, Working Paper No. 61, 1998).

⁷⁴ The White House, Office of the Press Secretary, *Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas* (May 4, 2009) 2009 WL 1179547 ("Today, President Obama and Secretary Geithner . . . are calling for reforms to ensure that our tax code does not stack the deck against job creation here on our shores.").

⁷⁵ I.R.C. §§877, 877A.

of international tax reforms designed to bring the U.S. system closer to those of the other OECD countries. The United States is no longer the dominant economic and political force in the world that it was in the latter half of the twentieth century. The globalization of business has taken place in a world in which capital and people are increasingly mobile. Like King Canute trying to hold back the tide, the U.S. government is attempting to use tax rules such as section 7874(b) to prevent global businesses from adopting legal-entity structures that legitimately minimize their global effective tax costs. It will not work, and is not worth the attempt.

VI. CONCLUSIONS

The 2009 guidance regarding section 7874 was developed by the IRS and Treasury at roughly the same time as the Administration's international tax proposals. Those proposals, if enacted, would make the tax cost of having a U.S. parent entity higher than ever for many multinational groups.⁷⁶ At the same time, the financial crisis and recession of 2008 and 2009 may have reduced the U.S. tax cost of expatriating to a new foreign parent through an inversion transaction falling under section 7874(a)(1). For some group owners, the effective transfer of more than 20 percent of their equity interest in the group to new investors via a private placement of FC stock, and the U.S. tax cost of the related inversion, would be acceptable trade-offs for the future benefits to be derived from positioning the group outside the increasingly onerous U.S. international tax rules.

The language and legislative history of section 7874 do not indicate that Congress intended to have the new foreign parent treated as a domestic corporation in that scenario. There is simply no valid legal basis for disregarding FC stock issued to new investors in exchange for cash in a private placement.

For groups considering an inversion resulting in a new foreign parent in a country in which the group has existing and continuing business activities (perhaps in a country such as Ireland or Singapore), the elimination of the safe-harbor test and the examples in the regulations regarding the business-activities test of section 7874, and the no-ruling position of the IRS, mean that a group would have to undertake the inversion without knowing whether section 7874 would apply.⁷⁷ The inability to know the tax consequences of a major transaction is a real

⁷⁶ See James Reardon & Jon Ohrn, *The Practical Effects of the Obama International Tax Proposals*, 2009 TAX NOTES TODAY 171-6 (2009).

⁷⁷ The IRS and Treasury have created uncertainty with respect to other issues under section 7874 as well. For a discussion, see PricewaterhouseCoopers, US Inbound Newsletter, Tax Consequences of Cross-Border Restructurings of Domestic Corporations and Partnerships Less Certain with New Temporary Regulations under Section 7874 (June 22, 2009), available at <http://www.publications.pwc.com/DisplayFile.aspx?Attachmentid=2202&Mailinstanceid=11696>.

problem, which only the IRS and Treasury (or Congress) can solve. The sooner the IRS and Treasury can produce new guidance regarding the level of business activity in the foreign country of incorporation that will be considered “substantial” when compared to the total business activities of the group, the better for all concerned.

